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CommentLetters@iasb.org.uk

14 October 2002

Proposed Amendments to IAS 32 and IAS 39 Financial Instruments

Dear Sir David

The International Swaps and Derivatives Association (ISDA) appreciates the opportunity to comment on the Exposure Draft of Proposed Amendments to IAS 32 Financial Instruments: Disclosure and Presentation and IAS 39 Financial Instruments: Recognition and Measurement.

Our members represent leading participants in the privately negotiated derivatives industry and include most of the world's major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such we believe ISDA brings a unique and broad perspective to the IASB's work on accounting for financial instruments.

We welcome some of the amendments that the IASB has made to its proposed standards. However, the latest exposure drafts continue to raise a number of concerns for ISDA, concerns that if addressed we believe would contribute to more robust and appropriate accounting standards.

In this letter we identify the main points that we wish to bring to the IASB's attention. In the appendices to this letter we set out our detailed answers to the questions posed by the Board in each of the exposure drafts and identify other areas of concern where no specific question was asked. Where possible, we present examples of why we believe these matters need to be addressed and propose possible solutions.

International harmonisation

ISDA supports the IASB's stated initiative of working closely with the FASB and other national standard setters towards international accounting harmonisation. We welcome several of the proposed revisions to IAS 32 and IAS 39 which will eliminate differences between US GAAP and IAS. However, we note some new differences have emerged in the proposals, which is clearly inconsistent

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with the convergence initiative. We believe the global nature of financial markets makes it critical that financial instrument accounting has international consistency. We recognise that, at this interim stage, differences do, and may continue to exist for a period of time, but we encourage the Board to work directly with its national counterparts on achieving consistency in the next phase. In this regard, to achieve consistent international answers will not merely be a matter of accepting one party's current solution but will require the parties to work together to develop better solutions. As we have already indicated, we believe that ISDA brings a unique and broad perspective to the IASB's work on accounting for financial instruments and members of our Accounting Committee would be happy to work with the IASB on this project.

Substance over form and faithful representation

ISDA supports the principles of 'substance over form' and 'faithful representation' identified by the IASB as Qualitative Characteristics of Financial Statements in its framework for the Preparation and Presentation of Financial Statements. However, ISDA is concerned that many of the proposals to amend IAS 32 and 39 appear to contradict these principles. In particular, in its drive for objectivity the IASB has removed from the draft standards the concepts of probability and economic compulsion. This means that the legal form of a contract will, in many cases, determine the accounting treatment. In order to achieve faithful representation, reflecting the genuine substance rather than the legal form, the exercise of judgment is inevitably required. In our detailed responses to the IASB's questions, we explore specific examples of this concern.

Separation of compound instruments

ISDA strongly disagrees with the principle of separation of financial instruments into the constituent equity and liability components. Under the rules, many commonly understood compound financial instruments, such as convertible debt, will be split into two or more instruments and buried in both the liability and equity sections of the balance sheet. We are not convinced that the separation required by IAS 32 has improved the usefulness of financial information. If the IASB retains the principle of separation then ISDA presents an alternative approach to separation in our answer to question 2, that more accurately represents the equity and liability components.

Derecognition

ISDA believes that the approach taken by the IASB towards derecognition does not have a sufficiently sound conceptual basis to represent a desirable approach for the long term and significantly more work is required as soon as possible. ISDA urges the IASB to consult with a broad range of industry bodies and to work closely with the national standard setters to develop a long-term solution which can be applied internationally. ISDA would be keen to contribute to such a project.

However, ISDA is aware of the shorter-term challenges facing the IASB to present a workable approach in the first quarter of 2003. Although ISDA believes that the approach presented in the IAS 39 exposure draft contains some significant flaws, with the short-term objective in mind, ISDA urges the IASB to address the worst of these flaws to achieve a more sensible interim solution. In our responses to questions 2 and 3 of IAS 39 we identify these flaws and attempt to present pragmatic solutions so that the approach can be made workable in the short term.

Valuation

In practice, the fair value of financial instruments requires the careful application of judgement to arrive at the most effective assumptions and estimates which underlie the valuation. ISDA believes that the standard should specifically acknowledge this. We are concerned that the drafting of IAS 39.95-100D is too prescriptive, would require significant changes to the valuation methods employed by dealers and a number of other types of entities and would not allow the natural evolution of valuation techniques.

Due process

ISDA appreciates that the subject matter covered by IAS 32 and IAS 39 is complex so that inevitably the exposure drafts are themselves lengthy and complex. However, in some cases ISDA believes the

drafts are not clear. Throughout our response, we identify key concerns about the lack of clarity and where this may lead to inconsistent interpretation. For example, in IAS 32 paragraphs 19 to 29G, ISDA is concerned that it is sometimes unclear as to which paragraph should be applied, in which order, and to which instrument. We believe that the IASB should carefully review the wording and make it clear which set of rules apply in which circumstances, so reducing the risk of different interpretations. Further, ISDA is concerned that the lack of clarity of may mean that we, and other respondents, may have misunderstood the Board's intentions and, as a result, not raised all the concerns that might otherwise have been raised.

ISDA is also concerned that the status of the IGC's implementation guidance relating to IAS 39 that has not been incorporated into the draft standard, is unclear. ISDA believes that the remaining implementation guidance should be considered and either incorporated in the standard or discarded. To the extent that the guidance is illustrative then the material could be included in an appendix, but to the extent that the guidance sets out principles, then it should be contained in the main text. At present the Board states that the "status of individual Q&As will be reassessed when the amendments are finalised". ISDA is unclear as to how this will happen.

ISDA believes that, for there to be an appropriate due process in the development of revised standards, further public exposure is required once the Board has clarified the inconsistencies, addressed the issue of the implementation guidance relating to IAS 39 and redrafted the standards. We recognise that, in the interests of time, full public exposure may not be possible. If this is the case we would be very keen to participate in a 'fatal flaw' review of the revised standards.

We have made every effort to be complete and clear in our response and, where possible, we have illustrated with examples. However, we would be pleased to discuss our comments with the Board or staff. To arrange this please contact either Sue Harding on 020 7888 2664 or Ed Duncan on 020 7330 3574 or at the above address.

Yours sincerely,



Sue Harding

Chair, ISDA European Accounting Committee



Shannon Warren

Chair, ISDA North American Accounting Committee



Ed A. Duncan

Assistant Director of European Policy, ISDA

Appendix 1 – IASB’s specific questions on IAS 32

Question 1 - Probabilities of different manners of settlement (IAS 32.19, 22, and 22A)

Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).

ISDA agrees with the general concept that the issuer of a financial instrument should classify it as a liability or as equity in accordance with the substance of the instrument. However, we believe that the approach for classifying particular instruments as liability or equity instruments contains some fundamental weaknesses that mean certain instruments would not be classified in accordance with their substance. ISDA’s key concerns are summarised as follows:

Commercial possibility

ISDA is concerned that the proposed changes which remove the concepts of ‘probability’ and ‘economic compulsion’, could mean that for certain transactions, form overrides substance. It is relatively easy to design an instrument that does not bestow on the issuer a strict contractual obligation to deliver cash or another financial asset. However, other terms can mean that there is no genuine commercial possibility of the entity avoiding settling the instrument by delivering cash or another financial asset. Alternatively, it is possible to design an instrument that meets the definition of a liability, even though in practice it is very unlikely that cash or another financial asset will be delivered. This is illustrated by the following examples:

- The redemption price of a redeemable share may be set at a level that is so unlikely to occur that the issuer’s obligation to redeem will never be met and therefore the share might appear to have the substance of equity. IAS 32.22 would assign the instrument as a liability.
- Reference to an independent variable could be so implausible that it will have no bearing on the behaviour of either party to the instrument or to the substance of the instrument. IAS 32.22 (A) would still require the instrument to be classified as a liability even though the instrument may have the substance of equity.
- The deletion of the example of escalating dividends in IAS 32.22 implies that only the strict legal form of a preferred share is important in determining its classification. As a result it may be required to be classified as equity when it has the substance of a liability. This suggestion is reinforced by the proposed additional guidance included in IAS 32.A21.

ISDA believes that classifying an instrument according to substance requires the probability of settlement to be considered. Whilst this introduces a degree of subjectivity, determining substance does often require judgments to be made. ISDA believes that the IASB should at least introduce wording to ensure that clauses which have no genuine commercial possibility do not drive the classification. In addition, for substance to continue to be the primary driver of the classification, it may be necessary to reconsider the classification, for example, in the event it becomes probable that the instrument will or must be redeemed, rather than merely at inception as required by IAS 32.19. This reassessment should consider facts as they exist at the time and any re-classification should not be

retrospective. ISDA also believes that robust disclosure should be given of instruments that have been reclassified through application of these provisions.

Linkage of transactions

ISDA believes that the concept of substance over form should extend to group accounts. This requires that transactions with various members of a group be considered as being all with the same economic entity. IAS 32.17 requires a financial instrument that is classified as minority interest (equity) by a subsidiary, to be classified as minority interest (equity) in the group accounts. ISDA is concerned that this classification remains at the consolidated level, even if the parent or another member of the group has a transaction which is linked that would mean that the overall group position is, in substance, a liability.

For example, whilst the subsidiary's instrument may have no guarantee of payment of dividends or liquidation amount, the parent may provide a guarantee of payment of dividends or liquidation amount, or both, which turns the substance of the combined transactions into a liability at the group level. Under the current provisions this would continue to be shown as an equity minority interest.

ISDA suggests that IAS 32.17 be clarified to indicate that, in addition to eliminating a parent's holdings of the instrument, the classification of the instrument at group level should be made based on the substance of the instrument to the Group, considering the instrument together with any related transaction of the parent or other entities included in the Group.

Contingent settlement

It is not clear how IAS 32.22A interacts with other parts of the draft standard, in particular, the section on convertible bonds in IAS 32.23 et seq and that on compound instruments in IAS 32.23 to 29G.

For example the convertible bond described in IAS 32.A24 could be amended so that conversion automatically replicates the action of a rational holder. In such a transaction, 250 shares are issued at maturity if their value exceeds 1,000. The application of IAS 32.22A could lead to the conclusion that the whole convertible bond should be classified as a liability. This would conflict with the requirements of IAS 32.23 to IAS 32.29, which would split the bond into its liability and equity components, and also with IAS 32.29C to G, which would split the bond into a liability and a derivative.

Question 2 – Separation of liability and equity elements (IAS 32.28 and IAS 32.29)

Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?

The principle of separation

ISDA strongly disagrees with the principle of separation of financial instruments into the constituent equity and liability components. Under the rules, many commonly understood compound financial instruments, such as convertible debt, will be split into two or more instruments and buried in both the liability and equity sections of the balance sheet. We are not convinced that the required separation of IAS 32 has improved the usefulness of financial information. In support of this argument, one example discussed by our committee relates to Enron. Enron issued a convertible bond in January 2001 for USD1, 250 million. If the equity component had been separated out, we understand that as much as USD650 million of the bond would have been presented in equity. Investors relying on the balance

sheet would have been surprised to find that this USD650 million of equity did not exist once Enron was in default.

Residual approach

In the event that the IASB continues with the principles of separation, ISDA agrees that the alternative methods of measurement should be limited. ISDA would then agree with the proposal, that the residual amount should be assigned as the equity component, as this is consistent with the definition of liability and equity contained in the IASB's framework.

However, we do not believe that the approach set out will result in the correct attribution being assigned between the two components, as it will lead to initial understatement of the liability component and overstatement of the equity component. The liability is understated because, if a bond were to default, the creditor claim would be the original par amount and not the accreted value. Meanwhile, the equity, which is initially overstated, will disappear over time as the incremental discount on debt is recognised as an expense.

Alternative approach

To address these concerns with the method of separation, ISDA proposes a simple approach to separation which could be applied to all convertible instruments. We believe the approach is simple in application and the results are clear.

At issue, the convertible debt is recorded on the balance sheet at its fair value. No portion is attributed to the equity option because in practice, the premium for the equity option is paid over time. Thus at inception its fair value is zero. In order to accrue interest, the normal borrowing cost for a debt instrument without the equity option is determined, reflecting any put and call options embedded in the instrument. This higher level of interest is accrued each period as interest expense. The difference between the coupon and the amount charged to interest expense would be credited to equity as the value of the equity option slowly becomes apparent as the instalments of the premium are "paid."

This treatment has the benefit of recording an interest expense commensurate with the company's borrowing rate. It also records the liability at its settlement amount. As a result, this approach does not overstate equity, but rather reflects the pattern by which the premium on the equity is received. The assumption that the equity option is paid up front has always been arbitrary. By the time the convertible bond reaches maturity the accounting treatment will be the same as that using the approach proposed in IAS 32.

We strongly urge the IASB to embrace this approach as it has many benefits of providing appropriate expense recognition, recording liabilities at their settlement amount and not overstating equity. It is also simple to apply and simple to explain. This approach could also be applied to other instruments that would meet the requirements for separation.

Complex instruments

It is clear that the complexity of the convertible bond market has increased so that there are a large number of structures containing multiple option components, for example, convertible bonds with put and call options on the bonds. ISDA believes that the IASB must expect that for complex products, even following the stated measurement approach, different results will be produced for different entities due to the complexity and subjectivity in valuing such instruments. For the more complex instruments, while it is possible to value the instrument as a whole, it is not in practice possible to assign a value to the components, due to their mutual dependence. Because of these reasons, a number of our members have stated that they often cannot and do not provide valuations to their customers as to the value of individual components of such instruments. In light of these complexities, if the Board continues with the approach as drafted, then ISDA believes the IASB should introduce specific wording so that where it is not possible to determine the split between equity and debt the instrument should default to being treated as a liability in its entirety, and carried at amortised cost.

Convertible bonds

ISDA also wishes to point out that the penultimate sentence of IAS 32.25, where a convertible bond is compared to a bond with detachable warrants to buy shares, is not always correct, as frequently a convertible bond ceases to exist on conversion whereas a bond with warrants does continue after the warrants have been exercised.

Question 3 – Classification of derivatives that relate to an entity’s own shares (paragraphs 29C – 29G)

Do you agree with the guidance proposed about the classification of derivatives that relate to an entity’s own shares?

ISDA believes that the new guidance represents a reasonable basis for classification but we are concerned that there are some significant drafting issues. ISDA’s key concerns are as follows:

Treatment of convertible debt

ISDA is concerned that it is unclear how paragraphs IAS 32.29C to G interact with paragraph IAS 32.25. Whilst IAS 32.25 ostensibly applies to a convertible bond, requiring the equity option to be treated as an equity instrument and the bond to be treated as a liability, this is inconsistent with IAS 32.29C to G which would require different accounting if applied to the same instrument. We understand that this was not intended and drafting changes are required, so that separated equity components are treated as equity, rather than as derivative assets or liabilities held at fair value.

The problem with the draft text of IAS 32.29C arises because a separated instrument is unlikely to be settled gross “for a fixed monetary amount of cash or other financial assets”. Rather, the (notional) consideration will be the ***extinguishment of a liability***, which will generally be a variable amount, in terms of its fair value (except presumably at maturity), although it is fixed in terms of its notional value.

ISDA recommends that to correct the drafting, the wording in IAS 32.29C should be amended so that the end of the first sentence reads ‘...for a fixed monetary amount of cash, other financial assets ***or extinguishment of a pre-specified financial liability***.’ Further guidance should then set out that, for this purpose, the fixed amount should be the specified liability’s notional value. This amendment to the drafting of IAS 32.29C would allow equity components of convertible bonds to be separated and classified as equity, and would remove the inconsistency with IAS 32.25.

Multiple Settlement Alternatives

ISDA believes that if the issuer cannot be required to relinquish cash or assets to settle an obligation, then the instrument should be classified as equity. Therefore, ISDA believes that the condition set out in IAS 32.29E: (a) that the issuer has an unconditional right and ability to settle with equity, is all that should be required to drive the classification. IAS 32.29E (b) and (c) focus on ‘past history’ and ‘intent’ to determine the appropriate treatment for situations where there is an issuer choice as to the settlement method.

By requiring the conditions in (b) and (c) to be met, the accounting would be unduly influenced by past practice and management intent. Past practice may not be a good guide for the future, especially as complex instruments can vary significantly in their terms. Further, the approach is inconsistent with IAS 32.22, in which the classification of a preferred share is simply driven by ‘a right to require’ and does not consider intent or past history.

Consistent with ISDA’s recommendations, the fourth column of the table in IAS 32.B.27 headed ‘Issuer Choice (no past practice of gross physical settlement)’ should be deleted and reference to past history also should be deleted from the third column.

In the event that the Board chooses to retain IAS 32.29 E (b) and (c) then ISDA believes that ‘past history’ and ‘intent’ should be rebuttable, where the substance of a current instrument would overcome the presumption.

Change in fair value of derivatives

ISDA believes that there is a drafting issue in IAS 32.29G, as the fair value of all derivatives will change, to some extent, as a result of movements in interest rates. As a result, ISDA is concerned that in applying this paragraph, virtually all derivatives would be classified as derivatives rather than equity instruments, which would be in conflict with the requirements of the preceding paragraphs. ISDA recommends that the wording be revised to reflect the fact that changes in fair value arising purely from the impact of interest rates on discount factors and the calculation of the forward price should not impact the classification of the instrument.

Further, a number of instruments exist where a fixed number of shares are exchanged for a fixed amount of cash plus interest calculated at a variable rate such as LIBOR. This variable rate interest represents the funding cost and helps serve to eliminate interest rate risk. However, the fair value of the instrument will fluctuate in part in response to the underlying interest rate, although clearly the main driver of value is the equity component. ISDA believes that where there is a secondary interest rate component, such as in this example, an instrument that would otherwise be classified as an equity instrument should still be classified as such if the substance of the instrument is equity. If the IASB pursues a separation approach then the interest rate component should be separated out as a derivative asset or liability and the residual equity component should be treated as such.

Accounting for forward sale of shares

We believe that the accounting set out in IAS 32.A35 does not intuitively follow from the main text. This is due to the fact that IAS 32 contains no recognition criteria for equity instruments. In determining when an equity instrument is recognised, we believe it is generally appropriate to determine when to recognise the associated asset, i.e. the consideration for the issue of the equity instrument. Further, ISDA suggests that the IASB provides clarity to the table in IAS 32.B27 to link it to the accounting in IAS 32. A.32 to A.36. This link should make it clearer that the forward sale with gross settlement will only be accounted for in equity at settlement.

Compound equity derivatives

In certain equity derivatives, several distinct components may be included in a single contract, packaged in this manner for sale to the market. Some components of the transaction may meet all the requirements to be an equity instrument of the issuer if they were issued separately, and others may not. ISDA believes that in applying a separation approach, the components that meet the definition of an equity instrument should be treated as such and any component that does not meet the definition should be treated as a derivative. This is best illustrated by some examples as follows:

i) *A physically settled, variable share, forward sale of an issuer’s own stock*

These transactions are common in the marketplace and have the following characteristics:

Assume that the share price of the issuer’s stock is €100 at the inception of the transaction. The variable share forward at maturity would require the issuer to deliver, in exchange for €100, 1 share if the share price is less than or equal to €100 at maturity, a variable number of shares equal to €100 if the share price is greater than €100 but less than €120, and .83 shares if the share price is above €120.

From the issuer’s perspective, the instrument described above can be broken down into the following components: a purchased put option on one share at €100, a written call on 0.83 shares at €120 and a right and obligation to sell a variable number of shares equal to €100 when the stock price is between €100 and €120. The first two instruments, if issued separately, would qualify under IAS 32’s definition of an equity instrument since the fair value of the contract is equal to the change in a fixed monetary amount for a fixed number of shares below and above

the strike prices of the options. The right and obligation to sell €100 worth of stock at fair value would meet the IASB's definition of a derivative but has no fair value even if separated.

ISDA does not believe that the difference in the number of shares in the two options, and the derivative that links the two, that has no fair value at any time should disqualify the entire transaction from being an equity instrument of the issuer. Thus, we would separate the forward sale at market component (the zero fair value sale) from the instrument and treat it as a derivative. The remaining put and call options would be treated as equity instruments. ISDA believes it would be misleading to ignore the overwhelming equity characteristics of this contract and treat it in its entirety as a derivative, recorded at fair value, solely because (1) there is a "derivative component" that has no fair value in the contract and (2) at different price levels the number of shares to be delivered changes commensurate with the terms of components that would otherwise meet the requirements to be equity instruments of the issuer.

- ii) *A unit structure that is composed of a debt instrument and a forward sale contract on a fixed number of issuer shares*

The debt has a longer maturity than the forward and thus the debt will be remarketed at the maturity of the forward. If the remarketing fails, the debt can be used to satisfy the holders' obligations under the forward. The coupon on the debt will be adjusted so that the proceeds raised upon remarketing will equal par. There are no caps or floors on the coupon reset. The probability of a failed remarketing is considered remote.

If the IASB does not accept ISDA's proposed changes with respect to the definition of a "fixed monetary amount" which would include the delivery of a "pre-specified liability" in satisfaction of the strike price, which we believe is preferable, then we have a further recommendation. ISDA believes it is imperative that the embedded credit derivative in the equity contract, that is the right to deliver an issuer obligation that may have a different fair value than the stated strike price, should be separated so that the equity contract, which has the predominant value in this transaction, receives equity treatment and is not tainted by a remote contingency. The separated credit derivative would be treated as a derivative and carried at fair value.

Earnings per share

ISDA is concerned that IAS 32.29F conflicts with the revised version of IAS 33, Earnings per Share, in the Improvements ED. IAS 32.29F states that an issued equity instrument subject to a written put option ceases to be an equity instrument. IAS 33.4 defines an ordinary share as an equity instrument that is subordinate to all other classes of equity instrument.

Following the logic of IAS 32.29F, an ordinary share with a written put option should not be included in the calculation of basic EPS. However, IAS 33.55 implies that the Board intends such shares to be included in the calculation of basic EPS. This conflict suggests that there is a conceptual problem with one of the standards, although ISDA believes that the proposed treatment in IAS 33 is correct. Given this conflict, we believe that IAS 33.55 should be amended to make it clearer that such shares should be included in the calculation of EPS, to help prevent the possibility of an entity manipulating its basic EPS by writing significantly out of the money put options on its own shares.

Question 4 – Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard

Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)

ISDA believes that the IASB should have a long-term objective of a single comprehensive standard covering Financial Instruments. However, in view of the short-term objective of finalising the

standards in the first half of 2003, consolidation of the standards should not represent a high priority matter. Selective high level cross-referencing maybe of assistance.

In addition, ISDA would like to point out an inconsistency in the treatment of application guidance between IAS 32 and IAS 39 that should be resolved. The guidance for IAS 32 is for illustrative purposes only whereas, for IAS 39, Appendix A is an integral part of the standard (while Appendix B to IAS 39 is illustrative only). ISDA believes that it is appropriate to present all examples in the application guidance and to represent them as illustrative only. Material that is not merely illustrative, but is needed to set out the principles, should be contained in the main text.

Appendix 2 – Areas not covered by IASB Questions on IAS 32

- IAS 32.1 (c) **Insurance contracts**
- & IAS 39.1(d) ISDA supports the inclusion of insurance contracts, that are in substance no different from other financial instruments, within the scope of IAS 32 and IAS 39. ISDA believes that this helps provide a level playing field across the industry and removes inconsistencies in accounting and disclosures for equivalent transactions. However, ISDA is concerned that the paragraph as drafted may be difficult to interpret in all but the most obvious cases, as insurance contracts involve the transfer of both financial and true insurance risk. For example, investment -type contracts will have some mortality risk at inception that reduces over the policy term to virtually nothing – should these contracts be treated as insurance contracts initially, but then be subject to IAS 39 in the later stages of their life?
- ISDA believes that additional guidance is required to ensure that there is consistency of application.
- IAS 32.4A&B **Commodity contracts**
- & IAS 39.6&7 ISDA agrees with the proposal to treat commodity contracts within the scope of IAS 32 and 39 where used as part of a trading activity. However, we note that the proposed revised IAS 2 is not consistent. IAS 2.1(c) is much more narrowly drafted. This is a concern, since it is likely that firms buying and selling commodities with the intention of selling them within a short period after delivery will, from time-to-time, hold stocks of the commodity at their financial reporting date. As drafted, a firm would be required to record a forward purchase of, say, oil at fair value and then, once it takes delivery of the commodity, record it at the lower of cost and net realisable value. This would result in any gain previously recognised on the forward purchase contract having to be reversed, which is presumably not the intention of the IASB.
- If the proposed revisions are made to IAS 32 and IAS 39 then equivalent revisions also need to be made to IAS 2.
- IAS 32.17 **Minority interest**
- ISDA believes that minority interest is unique in that it does not fit the definition of either a liability or equity. Minority interest does not represent an obligation that can be settled by the conveyance of an asset, nor is it an equity instrument that is residual within the parent entity. Minority interests have exclusive rights to their share of the assets of the subsidiary.
- ISDA concurs with the first sentence of IAS 32.17 *‘The minority interest that is recognised when consolidating a subsidiary is not a financial liability or an equity instrument of the parent.’* Further, ISDA agrees that in the consolidated accounts the minority interest should be shown separately from the equity of the parent. However, ISDA believes that inclusion in the equity section of the consolidated balance sheet, even though separate from the parent’s equity, could be misleading to investors. For example, it could be seen to overstate the residual interest attributable to group shareholders in the group accounts.
- ISDA notes that, in addition to having potential implications for the recognition and measurement of minority interests mentioned in the proposed basis for conclusions, the classification of minority interest as equity may have other implications. For example, calculations of earnings per share figures and the presentation of changes in minority interest within earnings or within equity, as changes in equity amounts are not normally presented in earnings. Finally, it is not clear whether this proposal

represents a resolution by the Board to adopt an Economic Entity approach over a Parent Entity approach. Evidence of both approaches is present within IAS. At a minimum, ISDA believes that the additional potential consequences of specifying the classification of minority interests should be resolved prior to proceeding with any change in this area.

ISDA believes that minority interest should be presented in a mezzanine category between the liability and equity sections of the balance sheet.

IAS 32.29 A&B Treasury shares

ISDA has a concern where an entity holds positions in its own shares as a hedge position for its market making activities. For example, if an entity is a market maker in derivatives based on an equity index, the entity may also hold the shares that make up the index as a hedge. If the entity itself is part of the index then this will include the need to hold its own shares. The number of shares held will change frequently as the hedge is rebalanced. Even though this is a trading activity, the entity will be required by IAS 32 to show the holding of its own shares as a deduction from equity and, as a result, will report unnecessary volatility in its trading profit or loss. ISDA believes that the IASB should consider an exemption for entities holding shares for these market-making activities.

ISDA raises this point particularly in light of the fact that paragraphs 16 and A8 of IAS 32 are subject to proposed changes and the new paragraphs 29C to 29G will result in more derivatives on an entity's own shares not being classified as equity. Therefore, ISDA has concern that there could now be a greater risk of a transaction and its economic hedge following asymmetrical accounting.

ISDA believes that with robust disclosure in the financial statements and specific documentation of the strategy and rationale, in these circumstances the IASB should allow an entity's holding of its own shares to be presented as a trading asset at fair value.

IAS 32. 31A Compound financial instruments

This standard does not deal with how an entity might account for the reacquisition (as opposed to settlement in accordance with its terms) of a compound financial instrument such as a convertible debt if it is separated. In particular, to what extent should an entity regard the acquisition cost as relating to the liability element and to the equity element? A pragmatic solution would be to allocate the cost in the same way as on issue.

IAS 32.33 – 41 Offset

ISDA is concerned that the offset rules set out in IAS 32.33 (b) allow offset only when the entity 'intends' to settle on a net basis or realise the asset and settle the liability simultaneously. These criteria are unrealistic and impractical. ISDA believes that where the entity has the unconditional right and ability to settle net, as demonstrated by the existence of a master netting agreement, then this should be sufficient to allow offset. This approach is consistent with the approach taken by banking regulators and in risk management by banks and provides more meaningful information to the user than the 'grossed-up' basis. It is also consistent with the approach under US GAAP, where there is a specific exemption for fair value amounts under a master netting agreement.

IAS 32. 42-94 Disclosure

ISDA does not agree with the proposed disclosures set out in IAS 32.77B, which we consider are likely to result in a wide range of disclosures. We are also concerned

that the requirements may result in disclosures which imply that valuations using models are inferior to, or less reliable than, quotations.

ISDA believes that the appropriate level of disclosure for a particular entity requires the exercise of judgment as to what is meaningful to the user in the context of the entity's business. Therefore, ISDA does not agree with prescriptive rules.

The following examples illustrate areas where we believe the disclosure requirements could lead to a broad range in the quantity and quality of information disclosed:

- The methods used for determining fair values could be too brief to convey significant information or be so extensive that the information is confusing. As an illustration, to state that options are valued using an options pricing model conveys minimal new information; to describe it as a 'modified Black-Scholes' adds little, and does not specify what modifications are made, whilst to set out in full the mathematical formulae underlying the model is too detailed for financial statements.
- As it is unclear what information is intended by the requirements of IAS 32.77B (b) and IAS 32.77B (c), some entities may disclose the valuation methods for each category of asset and liability whilst others may provide the amounts or proportions for each method used. As we noted above these requirements also imply that valuations determined by models are somehow inferior to quotations, a point with which ISDA disagrees.
- The requirement to disclose sensitivity to particular assumptions could lead to a broad range of outcomes. At one extreme this could result in long unwieldy disclosures that add little practical value and may imply that the amounts stated are unreliable. In particular, as there is usually no clear distinction between possible alternative assumptions and values that are not reasonably possible the proposed sensitivity analysis may provide little additional information of value to the users.

APPENDIX 3 - IASB's specific questions on IAS 39

Question 1 – Scope: loan commitments (paragraph 1 (i))

Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?

ISDA represents a broad spectrum of organisations with a wide divergence of opinion on this matter. Consequently, we do not answer the IASB's question.

Notwithstanding this, ISDA is concerned about the requirements in IAS 39.1(i) which deal with entities that have a past practice of selling assets resulting from their loan commitments. It is not clear whether the use of the word "entity" in this context applies to an entire group, an operating entity (e.g. a branch or subsidiary), or even some smaller unit within the group.

ISDA believes that differences between markets that a company may operate in can justify different treatments across its portfolios or business lines. For example, a multinational bank may be able to sell assets arising from its retail loan commitments in the US, and have a past practice of doing so. However, if there is no ready market to dispose of its European commercial loan commitments then it should not be required to treat them as held for trading, simply because of the past practice of its US operations. Furthermore, even where there is a market and past practice of selling some loans, ISDA believes that some differences in treatment should be permitted. For example, loans that fail to meet documentation requirements and cannot therefore be sold, should be exempt.

ISDA believes that the IASB should allow the assessment to be made at a sufficiently granular level so that the past practice is assessed for similar types of assets, ensuring similar treatment.

Question 2 – Derecognition: continuing involvement approach (paragraphs 35-57)

Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?

ISDA believes that the continuing involvement approach does not have a sufficiently sound conceptual basis to present a long-term solution. ISDA believes that there is a need for significant further work. ISDA urges the IASB to consult with a broad range of industry bodies and to work closely with the national standard setters to develop a long-term solution that can be applied internationally. ISDA would be keen to contribute to such a project.

However, ISDA is aware of the short-term imperative facing the IASB to present a workable approach in the first quarter of 2003. ISDA believes that the approach presented in the IAS 39 exposure draft contains some significant flaws. The worst of these flaws must be addressed prior to issuance of the standard for it to present a viable approach even for the short term. In answer to this question, ISDA identifies these key flaws and attempts to present solutions.

The main cause of ISDA's concern is that a transferor may have a continuum of levels of involvement with an asset after transfer, from substantial to minimal. As drafted, the proposed standard makes, in some cases, an arbitrary selection between types of involvement that constitute 'continuing involvement' and therefore preclude derecognition, and those that do not. In some other cases, the levels of continuing involvement that prevent derecognition are so limited that they have no

commercial relevance. We are also concerned that some of the accounting examples in the draft standard are flawed, and that the accounting by the transferee has not been sufficiently thought through.

1. Arbitrary determination of continuing involvement

Areas where the arbitrary nature of the facts that determine continuing involvement give ISDA concern include the following:

i) Servicing rights

The proposed standard excludes from continuing involvement the ongoing rights to service the asset. While we agree that servicing rights should not preclude derecognition it is not clear as to the conceptual basis for the Board's decision.

Further, as part of the consideration for servicing rights the transferor of the assets will often receive interest on the float (ie the cash received but not yet passed across to the transferee that arises naturally as part of the servicing). In this case, the transferor could be viewed under the draft standard as having reinvested cash flows for its own benefit. As a result, the transferor would fail the last sentence of IAS 39.41 (c) and consequently IAS 39.37 (a)(ii), meaning that it would not be able to derecognise the asset. In this case the accounting treatment is dependent on an arbitrary detail of the manner in which the servicer is remunerated.

ISDA does not believe that the last sentence of IAS 39.41(c) should in itself prevent derecognition in these circumstances. This sentence should be amended or clarified to indicate that the manner in which the servicer is remunerated should not in itself constitute continuing involvement.

ii) Fair value options and rights of first refusal

The draft standard proposes that a right of first refusal to require an asset at fair value is not continuing involvement (IAS 39. A9(d)), whereas a call option to reacquire an asset at fair value is (IAS 39.A9(i)). These two arrangements are economically identical yet result in opposite accounting treatments. As described below, ISDA believes that options at fair value do not represent sufficient continuing involvement to preclude derecognition.

2. Substance over form

The following are examples of where ISDA believes the level of continuing involvement to be too weak to preclude derecognition. In these areas the approach will often result in continued recognition of assets and liabilities that would not meet the definitions of assets and liabilities set out in paragraph 49 of the IASB Framework.

- i)* As indicated in the previous section, in the case where assets are transferred with an option to repurchase at fair value, the transferor has no control over, or participation in, the benefits associated with the asset. Yet the proposed standard requires continued recognition. ISDA disagrees with this treatment.
- ii)* Assets may be transferred with put or call options that are so significantly out of the money that there is no commercial possibility that they will ever be exercised (IAS 39. A9(g)). Once again, the proposed standard requires continued recognition. Clearly, this represents an extreme form over substance approach.

ISDA believes that in the examples (i) and (ii) above, the assets should be derecognised and the option recorded at fair value. Where the exercise is at fair value, or so far out of the money that there is no genuine commercial possibility of exercise, then this fair value will be minimal. Where the option exercise price is such that there is a genuine commercial possibility of exercise, then the asset should not be derecognised. While this amendment will require the exercise of judgement, as previously discussed, this is inevitable in achieving accounting according to commercial substance rather than legal form.

- iii) The transferor of an asset may enter into a separate transaction with the transferee such as an interest rate swap which, under IAS 39. A9(p), would not prevent derecognition. However, the transferee may be required to pledge the transferred asset back to the transferor as collateral for the swap, so as to eliminate the transferor's credit risk. The transferor has no right to receive the movements in value on those assets and has no right to dispose of them. The only way that the transferor will obtain such rights is in the event of default by the transferee. Therefore, the transferor's continuing involvement is only contingent on events outside its control.

We understand that the proposed standard would treat the existence of the pledge as continuing involvement in the assets originally transferred and would not allow derecognition because the pledge would result in the transferor 'reacquiring control of its previous contractual rights' as set out in paragraph IAS 39.37 (b) (i). ISDA believes that this treatment does not reflect the commercial substance of the arrangement.

ISDA believes that a more accurate representation of the economic exposure of the transferor would be to derecognise the original asset and recognise the separate swap transaction at fair value. Further, ISDA recommends that the definition of when events lead to the transferor 'reacquiring control of its previous contractual rights' should be more clearly set out so as to avoid different interpretations of this paragraph.

- iv) A transferor may be required to take back "charged-back" trade receivables. In most sales of trade receivables, the transferor must stand ready to remove a receivable from the pool if the underlying debtor returns the goods that generated the receivable. Currently, these "chargebacks" are accounted for as a payment by the underlying debtor when they occur, (even though the payment comes from the transferor) and are not viewed as a form of recourse.

ISDA believes that this approach should be continued and that this form of involvement should not disqualify the sale from derecognition. It is similar in nature to a right to put receivables back to the transferor in the event that a receivable in the pool is found to have failed the eligibility criteria at the inception of the transaction and thus is included in the pool in error.

- v) ISDA is concerned about the application of the continuing involvement criteria with respect to interest rate swaps between the transferor and transferee.

A significant portion of assets transferred to securitisation vehicles are done so in a manner that legally isolates the assets from the transferor in the event of the bankruptcy. This is generally a requirement of the rating agencies in order to rate the beneficial interests. If the interest rate profile of the notes issued by the vehicle differs to that of the assets transferred, then the transferor may enter into an interest rate swap with the vehicle. For example, where fixed rate assets are sold but the note issued has a floating rate coupon, the interest rate risk within the securitisation vehicle may be passed back to the transferor through an interest rate swap. As the transferor is not required to inject new funds into the vehicle, in the event that the assets in the vehicle default, payments on the interest rate swap will only be paid to the extent that there are funds available from the assets in the vehicle. As set out in IAS 39.A9(p), the interest rate swap would lead to continued recognition because payments on the swap are, therefore, ultimately conditional on payments being made on the transferred asset. Therefore, none of the assets sold to a vehicle, where there is an interest rate swap with transferor, may be removed from the balance sheet, even though the primary benefits and obligations of ownership have been transferred. ISDA does not agree with this result.

ISDA believes the appropriate treatment would be to derecognise the assets and to record an interest rate swap, at fair value. Leaving the assets on the books and establishing a liability for the proceeds does not represent the economic substance of the transaction.

3. *Flawed accounting*

ISDA has also identified areas where the accounting as set out is flawed. These reinforce our concerns with the concept of continuing involvement:

- i) *Call options held by the transferor*

As set out in IAS 39.A8(a) and the example in IAS 39B18, where a transferor retains a call option the asset cannot be derecognised and is to be recorded at *the higher of* its fair value and the option exercise price. Since retained call options normally have an exercise price higher than fair value at the time of sale, this treatment would immediately result in the transferor recording an asset, and a corresponding liability, both for a larger amount than the fair value of the asset. This becomes particularly problematic with higher exercise prices (and correspondingly lower probabilities of the option ever being exercised). For instance, if an asset is sold at its fair value of 100, but the transferor retains an option to reacquire it at a price of 4,000 (therefore very unlikely to be exercised), the draft standard requires the asset to be recorded at the figure of 4,000, with an offsetting liability for a similar amount. This is clearly not right.

Further, as the draft standard is worded it would not be possible to determine the appropriate accounting treatment of the not uncommon situation where an asset is sold and the transferor both retains a call option *and* grants a put option over the asset.

We believe that it would be more appropriate to derecognise the asset and record the fair value of the call option, with the gain on sale adjusted for the fair value of the call.

However, if the IASB moves forward on the continuing involvement model, we strongly believe that if the asset is not derecognised, the only practical treatment is to record it at its fair value, while the corresponding liability should be recorded at the fair value of the asset, minus the fair value of the option. This gives the same result as the draft standard when the fair value exceeds the exercise price but, where the fair value is below the exercise price, gives a more meaningful indication of the value of the asset to the transferor without causing the transferor to record a loss. In the case of available for sale assets, changes in the recorded value of the asset and the corresponding changes in the value of the liability should both be taken through equity, so that they offset. ISDA believes that the most appropriate accounting treatment for a put and call option combination (assuming that the asset is not derecognised) is to continue to record the asset at its fair value.

ii) *Double counting*

Another problem with the derecognition proposals is the example given of a sale of a portion of a financial asset with subordination, as set out in IAS 39.B4 to B17. In this example, although Company A sells 90% of its loan portfolio, the illustrated accounting requires it to derecognise about 90% of the loans and also recognise new assets equivalent to about 10% of the value of the original portfolio. ISDA is concerned that this results in double-counting the retained interest. Not only does this not make intuitive sense, but it also does not clearly follow from the requirements of the main text of the standard.

In this example, Company A continues to show in its balance sheet assets at a little over 2,000, although the maximum amount that it is at risk of losing is only 1,000. While a good argument can be made for requiring recognition of new assets for the value of the service rights and the interest-only strip, we believe the retained loan asset should be correspondingly recorded at a lower amount to reflect its fair value. Meanwhile, to record, in addition, a new asset worth 473 for the “subordinated residual interest” can only be duplicative of the loan asset already recorded.

The above problem is best understood by comparing the example given to an alternative scenario, where 90% of a loan portfolio is sold and the originator gives a *guarantee* of the first 10% loss on those loans sold, without providing its retained assets as subordination. In this new scenario, the company can be required to pay out money and could suffer losses of up to 20% (ie the 10% of the portfolio retained *plus* the first 10% loss on those loans transferred). While this scenario is very different in terms of the facts from the example given in the appendix, it would appear that the required accounting treatment would be very similar. But, unlike the example in the appendix, in this case the accounting treatment *would* make intuitive sense.

4. *Transferee accounting*

IAS 39.28 permits a transferee to recognise a transferred asset only when the transferor is permitted to derecognise it. If, therefore, the original transferor transfers an asset with an option of the type described in paragraph 2 (i) or (ii) above, the transferee will be required to show the asset as a loan even though it enjoys substantially full access to the commercial benefits of the asset. ISDA believes this treatment is incorrect and will lead to misrepresentation of the financial position of the transferee.

Further, if the transferee then sells the asset, without a similar option, the required accounting is unclear. Is the transferee required to record a short position in the asset (ie a liability), and to continue to record this liability and the 'loan' to the transferor until the option expires? Where the transferee has a put option to return the asset, but has sold the asset in the market, should the transferor still record the asset? Also, should the new transferee account for the asset as its own – not being aware of the original option – even though this will mean that two entities will record the same asset in their balance sheet?

These questions help illustrate our concern that continuing involvement, as drafted, lacks a sound conceptual basis. We are also unconvinced that the accounting by the transferee should necessarily be symmetrical with that of the transferor. Although more work is needed to derive a sound method of accounting, the recommendations we have made in response to this question will, in the short term, help reduce the inappropriate accounting that will otherwise be required.

Question 3 – Derecognition: pass-through arrangements (paragraph 41)

Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?

Our response to this question needs to be read in the context of the concerns expressed in our response to question 2, above. In that response, we explained that ISDA believes that the continuing involvement approach does not have a sufficiently sound conceptual basis to present a long-term solution. In the interests of finding a short term workable solution for the continuing involvement model we set out our key concerns with the model, and present pragmatic solutions to these concerns. Here we apply the same approach to the pass through arrangements.

The pass through arrangements are of particular relevance to securitisations. In this context, assets are frequently transferred from an originator to an SPE which then issues notes to noteholders. The originator may have derecognised the assets to the SPE in line with IAS 39.37(a) (i) or (ii). The pass through arrangements would then apply, as drafted, not only to the transfer from the originator to the SPE, but also to the transaction between the SPE and the noteholders, in the SPE's own accounts. In this way, it is possible for certain transactions to be fully derecognised by the originator, even where SIC 12 requires the SPE to be consolidated by the originator.

ISDA believes that the single entity accounts of the SPE should not be "empty". It is the SPE rather than the originator that the noteholders look to for performance on their notes and they will expect its accounts to record the assets backing their investment. This outcome reinforces our concern that the approach towards derecognition requires significant further work to develop a long-term solution.

In spite of this, ISDA believes that the pass through approach is workable as a short-term solution, although it is unclear how a number of real-life transactions would be treated under the provisions. Common transactions are set out below, along with specific challenges concerning the application of the pass through arrangements.

- i) In a simple repackaging, the SPE purchases a fixed rate bond, the SPE enters into a fixed for floating interest rate swap and then issues floating rate notes. Under the terms of the swap, the SPE swaps the interest receipts on the fixed rate bond asset for the floating rate coupon due to

the noteholder. The settlement between the SPE and the swap counterparty will be the net difference between these two quantities. Therefore, the SPE pays to the noteholder a combination of cash that it earns on the asset and an amount it receives under the swap. To apply the pass through requirements effectively requires the underlying asset and swap to be viewed in combination, but it is not clear from the text as to whether this interpretation is correct. IAS 39.A9 (p) states that a swap with the SPE would not preclude derecognition by the original transferor, but for the SPE itself to derecognise the asset would appear to contravene the offset rules of IAS 32.

- ii) There are common structures which include liquidity arrangements. For example, where commercial paper (CP) is backed by assets, such as trade receivables, mortgages or credit card receivables, the CP should be repaid or refinanced from the receivables. However, the CP has a maturity date and will be repaid at that time either directly from the receivables or, if there is a maturity mismatch, by the liquidity provider. The liquidity provider could be the transferor or a third party. Once again, to satisfy effectively the pass through criteria requires the assets and liquidity arrangements to be viewed as a portfolio.
- iii) In a credit linked note transaction, the SPE usually only pays the cash flows it receives from the asset to the noteholder if the reference asset underlying the credit-linked note does not default. Usually in these structures, a collateral asset is transferred to the SPE and there is a credit default swap with the same reference asset as the credit linked note. This credit default swap would be either with the transferor of the collateral or a third party. If there is a default of the reference asset, the SPE either sells the collateral asset and delivers the proceeds to the credit default swap counterparty or delivers the actual collateral asset. In return, the credit default swap counterparty either sells the reference asset and delivers the proceeds to the SPE, or delivers the actual reference asset. The SPE then delivers what it has received from the credit default swap counterparty to the noteholders. Therefore, the SPE's obligation to transfer cash flows to the noteholders is contingent. ISDA believes that specific guidance is required to make it clear whether cash flows which are contingent in nature meet the pass through tests.
- iv) Within securitisations it is usual for payment to the noteholders to occur on regular coupon dates even though the cash from the underlying assets may occur throughout the period. ISDA assumes that just because the cash is paid to the noteholders on regular contract dates should not represent a 'material delay' as set out in IAS 39.41 (c). We have already commented on the reinvestment of cash in our discussion of remuneration of asset servicers in our answer to IAS 39 question 2, above.

In each of these areas more guidance is required to clarify the accounting treatment.

Question 4 – Measurement: fair value designation (paragraph 10)

Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?

Yes.

ISDA also believes that there are limited situations that justify designating financial instruments as held for trading subsequent to initial recognition to better reflect the purpose for which a financial instrument is held. For example, in consolidated accounts the treatment of assets that are sold from one group operation to another, say from an investment entity to a trading or insurance operation, where all assets are designated as held for trading.

Whilst we appreciate such a provision could be open to abuse, we consider that it would be possible to impose appropriate restrictions, which together with explicit disclosure requirements of gains and losses made on such transfers, together with unrealised gains and losses on assets held for purposes

other than trading, would prevent abuse and help further the Board's objective of allowing more use of fair value.

Question 5 – Fair value measurement considerations (paragraphs 95-100D)

Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95–100D of the Exposure Draft? Additional guidance is included in paragraphs A32–A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?

In practice, the fair value of financial instruments requires the careful application of judgement to arrive at the most effective assumptions and estimates which underlie the valuation. ISDA believes that the standard should specifically acknowledge this. We are concerned that the drafting of IAS 39.95-100D is too prescriptive, would require significant changes to the valuation methods employed by dealers and a number of other types of entities and would not allow the natural evolution of valuation techniques.

We have six main concerns with the proposals of how to determine fair value:

a) *Quoted prices*

ISDA disagrees with the additional wording in IAS39.99 which requires a quoted price to be used when it is available. Whilst we accept that the quoted price is often the best determination of fair value, it is not always so. ISDA believes that the IASB should return to the original drafting and allow entities to diverge from the quoted value when it is industry practice (for example the valuation of derivatives), or where the quoted price is unreliable.

b) *Illiquid holdings*

It is unlikely that the price quoted for a normal trade will be achieved when disposing of a large block of securities, given that in most markets there will be insufficient liquidity. In such circumstances it is neither sensible nor prudent to measure the large block of shares at the quoted price, yet this is the treatment required by the draft standard. While use of a quoted price avoids the need for subjective judgement, for a large transaction, the quoted price is unlikely to represent what might be achieved between willing parties. Therefore, it is likely to result in the recording of profit which cannot be realised in practice.

A related issue is the concern that IAS39.99 places too much emphasis on the apparent quality of published price quotations in an active market. While in many markets use of quoted prices would indicate both objectively and fairly the fair value of an instrument, the definition of an active market as provided in the paragraph will include many markets where the quoted price (while being available for trading a small quantity of an instrument) would not be regarded as a sound indication of fair value and other valuation methods may be more valid.

Another example of this concern relates to using the volatilities implied in low volume listed derivatives to value high volume or high notional value OTC derivative contracts. Instruments may trade differently in each market due to the different liquidity profiles of each market.

c) *Bid and offer prices*

It is unclear as to the meaning of the term “matching asset and liability positions” in IAS 39.99. It is possible to interpret this extremely narrowly, such as where an entity is both long and short the same financial asset. However, others may take a much wider view and apply this where the “matching” instruments are sufficiently similar to provide an effective hedge but which are by no means identical. Without further guidance an inconsistent approach is likely to be taken, reducing comparability of financial statements prepared under this standard.

The valuation methodology originally out in the G30 report and now accepted by the Basle II regulatory capital framework, requires that derivatives portfolios of dealers should be valued at

mid-market levels, less specific adjustments, or at appropriate bid or offer prices. The specific valuation adjustments are designed to allow for expected future costs such as unearned credit spread, close out costs, investing and funding costs and costs of administration, all of which will be taken into account by a dealer in setting his bid or offer price. These considerations are consistent with the paragraphs on valuation techniques where there is no active market, as set out in IAS 39 100(a) to 100(d), but the depth of liquidity in the vanilla swaps markets and the availability of quotes implies that much of the swaps markets would be covered by IAS 39.99. ISDA is concerned that there is a potential conflict between the principles discussed above and the requirements of IAS 39.99. Even though an entity may be a counterparty to two offsetting swap positions which are identical, it would be inappropriate to use mid market prices as the firm will still be exposed to ongoing credit and administration costs, which should be reflected in the measurement of the swaps.

d) Commissions and bid : offer spread

In many markets, the bid:offer spread represents or includes the dealer's profit margin and no further commission is payable by the buyer or seller of the instrument. Consequently, applying paragraph 72A, the fair value determination will be different depending on the market convention of whether the dealer explicitly charges a commission or does so implicitly, through the quoted bid:offer spread. This inconsistency needs to be resolved and ISDA believes that it is the treatment of transaction costs which is wrong: it is inappropriate not to take account of the cost of disposing of an asset when arriving at its fair value, otherwise profits may be recorded on revaluation of a trading book instrument which are not capable of being realised in practice.

If entities had to recognise the transaction costs of the disposal on an asset in its valuation, they would often need to record a loss as soon as the asset is acquired. ISDA understands that this is an important concern, but believes that it is more relevant for assets which are available for sale, and less so for assets held as part of a trading book. Clearly costs of disposal are irrelevant to debt or loan assets held to maturity since at maturity they mature into cash. ISDA holds this belief because:

- in a trading book, the point of trading is usually to make money from short term changes in market prices, after taking account of all transaction costs, and the reported result should reflect this; and
- trading book gains and losses are recognised in the income statement, which is a more sensitive measure of performance than changes in equity, and so should be subject to more rigorous profit recognition criteria.

While ISDA is not in favour of introducing unnecessary extra complexity into the standard, the inclusion of transaction costs for trading book business would provide the most appropriate method of measuring trading performance and, for the trading book, would eliminate the conflict referred to above, where the market convention "buries" transaction costs in the bid:offer spread.

ISDA believes that transaction costs should also be included in measuring available for sale assets (since they are available for sale), but believes this issue to be less serious since gains and losses are only recorded in equity.

e) Short duration receivables

Whilst more related to the application of amortised cost than fair value measurement, we believe it would be helpful to retain the guidance in IAS 39.74, stating that short duration receivables with no stated interest rate are normally measured at original invoice amount unless the effect of discounting would be significant.

f) Practical accounting

The example given in IAS 39.72A is an unnecessarily complex way of accounting for the acquisition of a financial asset. If the commission payable on the purchase of an asset will need to be recognised as a

loss in profit and loss at the first financial reporting date, then it would be much simpler (and would give exactly the same result) if written off at the time of acquisition.

Question 6 – Collective evaluation of impairment (paragraphs 112 and 113A-113D)

Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A-113D?

ISDA agrees that an asset that has been individually assessed for impairment and not found to be individually impaired should be included in a group of assets with similar credit risk characteristics that is collectively evaluated for impairment. However, ISDA does not agree with the revised methodology for measuring such impairment as set out in IAS 39.113A to 113D (and 69(a) as amended).

Paragraphs 111 to 114 of the existing IAS 39 reflect the normal practice of most banks for the measurement of loan contracts, in which provision is made for *existing* impairment. The proposed revisions to IAS 39.112 are also consistent with the practice of many banks, as existing loan losses may not yet be explicitly recognised but are, nevertheless, believed to be *latent* in the portfolio, and an estimate of the latent losses can be arrived at by a collective evaluation for impairment.

However, the proposals in paragraphs 113A to 113D, especially as illustrated by the example given in paragraphs B 32 to B36, may potentially move beyond recognition of existing losses to a determination and recognition of expected future losses over the life of the portfolio. At its most extreme, this would be a form of fair valuation, albeit with no subsequent adjustment for changes in the discount factor. While there is theoretical merit to the approach proposed, it is very different from that used by many banks. There would also be significant practical problems in applying this approach as the loss probabilities would need to be reassessed and new effective interest rates calculated every time a new loan is made, as well as a need for major changes in systems and procedures. The proposed changes would be both fundamental and increase complexity, and so inconsistent with two of the Board's objectives in revising IAS 39. Further, most banks would not be able to make the required changes in systems and procedures in time to be able to meet the expected timetable for the new standard's implementation.

As well as the challenge of systems and procedures, in some cases there may be significant practical problems in determining default probabilities for the majority of loans made by banks, although this will vary with geography and the type of lending business. Most loans are not rated by an external agency and other statistical data is not always available, especially outside North America. As a result, the level of precision implied by the example given in paragraphs B32 to B36 could not be achieved for many portfolios. It is probably not coincidental that the example describes the portfolio as "BB", implying that the loans in example portfolio are to rated entities.

In addition, this proposal would result in expected loan losses being reflected in the interest margin rather than as credit losses, so reducing the transparency of banks' accounts.

This proposal deserves further evaluation as part of a longer-term programme to develop the accounting treatment of financial instruments, but it would be premature to incorporate it into a standard at this time. The programme should be carried out in conjunction with the national standard setters, including AcSEC in the US which is currently developing an approach that is based on *existing* losses.

ISDA is also concerned about the application of the effective interest rate method for loans subject to prepayment risk. According to the definition given in paragraph 10, the effective interest rate for such loans should be determined based upon the expected stream of cash receipts and should take account of all fees expected to be received, which would presumably include any penalty payments made by customers in prepaying their loans. In the UK retail mortgage market, for example, this would result in the premature recognition of income where borrowers prepay and incur penalty charges. We do not

believe it is prudent or appropriate that estimated penalty income is anticipated through the interest margin.

Question 7 – Impairment of investments in available-for-sale financial assets (paragraphs 117–119)

Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?

ISDA does not believe this change is required.

The change means that impairments of available-for-sale assets would be treated differently from most other impairments recognised under International Accounting Standards. In particular, the treatment would differ from the impairment of originated loans and receivables and investments designated as held-to-maturity under IAS 39; inventories accounted for under IAS 2; property plant and equipment accounted for under IAS 16 and other assets subject to impairment under IAS 36. Whilst we understand that the IASB's position is consistent with the US practice of not allowing reversals, we do not believe that the goal of international harmonisation should result in inconsistencies within the IASB's literature.

Question 8 – Hedges of firm commitments (paragraphs 137 and 140)

Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?

Yes. However, ISDA also sees the merit of permitting either approach. This is particularly so as US GAAP permits both approaches for hedges of foreign currency denominated firm commitments. In IAS 39.C.105 there is a note that states that the draft standard is now consistent with US GAAP. However, it is our understanding that this is not the case as US GAAP permits both approaches for foreign currency hedges of firm commitments.

Question 9 – 'Basis adjustments' (paragraph 160)

Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?

No.

ISDA believes that the gain or loss on a related hedging instrument is a directly attributable cost of an asset or liability, similar to interest capitalised under IAS 23. ISDA believes that the proposed change would also make it much harder for entities to track gains or losses on hedging instruments, especially for hedges of long-term assets and liabilities.

Question 10 – Prior derecognition transactions (paragraph 171B)

Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (ie that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?

While we understand the theoretical benefits of restating for assets previously derecognised, it will not be possible to examine every transition undertaken in previous years to determine if it should now be treated differently. Therefore, we believe that the results of applying this approach will be misleading. As a result, ISDA supports a grandfathering approach.

Appendix 4 – Areas not covered by IASB Questions on IAS 39

IAS 39.10 **Originated loans and receivables**

ISDA is concerned that the new requirement for originated loans and receivables to have “fixed or determinable payments” is not fully explained. As this is a term defined in US GAAP, ISDA is concerned that SEC registrants will apply the US definition, which may be different to the Board’s intention. Therefore, ISDA recommends that the Board define this term.

IAS 39.10 **Effective interest method**

ISDA has concerns with the changes to the definition of the effective interest method. In particular, ISDA believes that using “contractual” rather than “expected” cash flows could be problematic for some instruments.

For example, a ten-year convertible loan contains an embedded put option exercisable four years after issue. The option gives the holder the right to put the instrument back to the issuer at par on that date. However, the liability and equity components are determined at the outset and the put option will not be treated as an embedded derivative (IGC Q&A 23-11 and IAS 39.A4(g)). The liability will be treated as a loan issued at a discount (with redemption in ten years). If it becomes likely that the put option will be exercised, the entity will not be allowed to accrete additional interest over the first four years, but must wait until the end of year four and recognise a large loss on that date.

ISDA believes that any premium or discount on a liability should be accrued over the period to the first date when the entity can be required to redeem the instrument.

ISDA is also concerned that the change makes the standard inconsistent with IAS 18.31 which suggests that *expected* payments should be used in the case of interest earned.

In addition, ISDA is concerned that the requirement to apply the effective interest method over the period to the next market-based repricing date would require any discount on a floating rate loan to be recognised over the period to the first reset date. This is reinforced by the final sentence of IAS 39.76. We believe that an illustrative example should be included to set out how a floating rate borrowing with issue costs should be accounted for.

IAS 39.19 **Originated loans and receivables in business combinations**

ISDA agrees that originated loans and receivables acquired in a business combination should continue to be treated as originated loans after the business combination. However, we believe that the appropriate test should be that the acquired entity *would have been able to* classify them as originated under IAS 39 had it prepared its financial statements under International Financial Reporting Standards (“IFRS”). This presents a consistent result as otherwise the specific GAAP previously used by the acquired entity might prevent this classification by the acquiring entity.

Further, we believe that there are other situations following business combinations accounted for as acquisitions where it would be inappropriate to follow the classifications used by the acquired entity, e.g. if the acquiring entity designates all instruments as held for trading but the acquired entity did not (or vice versa). ISDA is concerned that it is currently unclear as to what extent these classifications can be changed on acquisition and we believe that the Board should clarify this matter.

IAS 39.23 **Embedded Derivatives**

ISDA believes there is a problem with the drafting in that one condition that appears to have been omitted is that the standalone derivative should be within the scope of IAS 39. Further, the host contract should only be accounted for under IAS 39 if it is a financial instrument *that is subject to the provisions of IAS 39*.

IAS 39.82

Puttable investments

ISDA believes that there are situations when puttable instruments could be appropriately classified as held-to-maturity. Whilst paying for a put feature may often be incompatible with an intention to hold the instrument to maturity, this will not always be the case. ISDA believes that the test set out in IGC Q&A 83-3 is appropriate and should be adopted.

IAS 39.86(A)

Anticipated credit downgrades

ISDA believes that the additional guidance from IGC Q&A 83-7 should be incorporated into this paragraph. In particular, there should be guidance on the treatment of credit downgrades that could be anticipated on acquisition, such as moving down a step within a class.

IAS 39.113

Impairment – financial guarantees and credit insurance

In addition to collateral, ISDA believes that the recoverable amount should reflect related financial guarantee and credit insurance contracts, which are commonly used but which are normally outside the scope of IAS 39 and, instead, within the scope of IAS 37.

This would prevent measurement anomalies, e.g. if it is only probable that a debtor will default but virtually certain that the guarantee will perform in the event of default. Under the current rules, the impairment loss on the asset would be recognised when it becomes probable but no credit could be taken for the guarantee until such time as the impairment is virtually certain.

This issue also applies to other impairments dealt with in IAS 39, for example, collective impairments of financial assets carried at amortised cost (IAS 39.113A) and impairments of available-for-sale financial assets remeasured to fair value (IAS 39.117 to 119).

IAS 39.A4(c)

Termination/extension options

and (g)

There is an inconsistency in IAS 39 appendix A which can be demonstrated by a simple example. Two fixed rate borrowing arrangements have the same terms except that the first is a four year loan that allows the borrower to *repay* without penalty at the end of year three, while the second is a three year loan that allows the borrower to *extend* the term for another year at the end of year three. In the first case, IAS 39.A4(g) regards the option to be closely related to the host, yet for the second IAS 39.A4(c) regards the (commercially identical) option as *not* closely related. Therefore, despite the transactions having the same economic form the treatment is different. This requires reassessment so that consistent results can be achieved.

IAS 39.A7(a)

Embedded Derivatives.

ISDA finds the purpose of this paragraph unclear. One interpretation is that virtually *all* floating rate instruments would contain embedded derivatives that are not closely related to the host as they all contain a theoretical possibility of doubling the holder's return and generating a return twice that of the host. ISDA does not accept this treatment and believes the original drafting of the paragraph should remain.